# Law and Economics
## Session 9
### Contract Law 1

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- Standard economic models assume costless enforcement of contracts.
  - Yet there are complex legal doctrines for how to interpret and enforce contracts, and a costly legal system to do that interpretation and enforcement.

- What promises should be enforceable by law?

- What should be the remedy for broken promises?

- For a promise to be enforceable, there must be a bargain.
- Elements of a bargain:
    - Offer
    - Acceptance
    - Consideration

- Expectation damages:
    - The promisee is entitled to the benefit that he would have obtained from performance of the promise.
    - Requires courts to ask counter factual questions:

- Contracts allow commitments, which encourage cooperation.
- Example:
  - Contracted quality level
  - Deferred transactions

- The buyer pays $10 to the contractor. If the contractor works, it costs $5 to the contractor, but the work creates the value of $15 to the buyer. If the contractor shirks, nothing is created and the contractor keeps the $10. If the buyer does not pay, no deal occurs.
- Game tree without contract enforcement
- Game tree with expectations damages

- Under expectations damages, a contract will induce performance when optimal and induce breach when optimal.

- Example: Buyer/contractor example, where
  - 50% chance that construction costs $5
  - 50% chance that construction costs $20

- Reliance:
    - The effort that promisee makes to increase the value of the promisor's performance to him, in anticipation of the performance.
    - E.g., buying a chair that matches a custom-made desk
- Example: Buyer/contractor example, where:
    - Buyer values project at $18 with reliance
    - Buyer values project at $15 without reliance
    - Reliance costs $2

- Simple Expectations Damages
  - Award expectation damages given actual reliance decision.
- Perfect Expectations Damages
  - Expectation damages assuming optimal reliance decision.

- Coase Theorem applied to contracts:
  - With low transaction costs, parties will bargain over and specify the optimal contract decision for all possible contingencies.
- But bargaining takes time and money, so a lot gets left out.

- Courts can try to fill in gaps to make incomplete contracts work better.

- The parties will leave a gap in a contract when

  Writing Costs > Cost of contingency $\times$ prob. of contingency

- Because the number of contingencies is potentially infinite, all contracts will have gaps

- Suppose that a strike occurs with probability .02. If it occurs, C can bear the risk at the cost of $500. B can bear it at the cost of $800.

- If the transaction cost (= the cost of including the clause in the contract) is more than $6, it is optimal to leave a gap.

- Courts can supply default rules to fill in gaps.
    - If parties like the default rules, they save time.
    - If they don't like the default rules, can can contract around them.
- Thus:
    - Courts can reduce bargaining costs by providing good default rules.
    - An effective approach: Impute terms that the parties would have set had they taken the time to bargain over the missing contingency.

- Which party could better foresee or absorb the risk?
  - Construe the provision against this party.
- Examples:
  - Perhaps the union could better foresee a strike occurring.
  - Unexpected disruption due to bad weather, where the contractor can pay $2000 to avoid delay or the buyer can extend lease for $1000.

- Sometimes courts invalidate contracts or invalidate terms.

- Mental Capacity:
  - People who are not mentally capable of understanding a contract (or are intoxicated when signing a contract) should not have a contract enforced against them
  - This would reward exploitation of mentally incapable people.

- Duress:
  - An agreement extracted by a threat should not be enforceable
  - This would reward threatening activity.

- Externalities:
  - An agreement that harms a third party shouldn't be enforced on efficiency (public policy) grounds.
  - The parties don't account for the external costs in their contracting, so the law should discourage these types of provisions

  - An important example of this type of regulation is monopoly – cartel agreements, wage-fixing agreements, etc. should not be legally enforceable.

- Asymmetric information:
  - An agreement extracted by deception shouldn't be enforced
  - Enforcing these agreements would reward costly deceptive behavior.

  - Similarly, imposing a duty to disclose can reduce adverse selection problems.

- One of the key functions of contracts we identified was in enforcing deferred obligations to allow for relationship-specific investments to occur.
  - The seller could "defect" on quality after receiving payment

- But in repeated games, parties can cooperate without contract enforcement.
  - They can punish each other in future rounds for defecting today.

- Therefore, in durable long-run relationships, contract law is less important.

- Contract law is most important in one-shot, high-stakes transactions.